

**Ministry of Economic Affairs**

**Ministry of Finance**

## **Updated Danish convergence programme**

### **1. Introduction**

Denmark hereby submits an update of the convergence programme of November 1998<sup>1)</sup>.

The convergence programme is based on the Government's multi-annual structural and welfare policy programme, which, among other things, establishes the following targets for economic developments through 2005:

- The surplus of the general government budget should be kept above 2 per cent of GDP
- Public debt should be reduced noticeably in per cent of GDP
- Growth in government consumption should be lowered to 1 per cent annually
- The tax burden should be reduced
- Unemployment should be reduced to approximately 5 per cent
- The number of recipients of transfer payments should be reduced significantly
- A sizeable reduction of foreign debt

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1) The previous convergence programme was the first in accordance to the Council Regulation concerning the Stability and Growth Pact (no. 1466/97). According to the regulation the euro-participating countries must present stability programmes while the other countries must present convergence programmes. The update of the Danish convergence programme is submitted to Parliament.

Danish economy has fulfilled all convergence criteria since June 1996. The economic policy strategy and the economic targets set forth in “Denmark 2005” are still in compliance with the Stability and Growth Pact and the Broad Economic Policy Guidelines recommended by the Commission.

According to the Edinburgh-decision Denmark does not participate in the single currency. Since January 1<sup>st</sup> 1999 the fixed exchange rate policy has been oriented towards the euro. Denmark participates in the new exchange rate mechanism ERM II with a  $\pm 2\frac{1}{4}$  per cent fluctuation band.

Economic policy is designed with the aim of ensuring stability in the Danish economy and obtaining a sustainable economic development. The stability-oriented economic policy supports the structural policy, where continued structural improvements, especially in the areas of taxes and labour market, are implemented to attain the economic targets.

The Danish economy is very dependent on international developments especially in the EU area, which accounts for around 70 per cent of Danish foreign trade. Therefore, the Government attaches great importance to the creation of stable economic developments in Europe i.a. through the broad guidelines of economic policies and employment guidelines.

## **2. Economic policy**

Five years of a rather strong economic upswing together with structural improvements have led to a significant improvement of the general government budget and a reduction in unemployment to around 4½ per cent of the labour force (according to the Eurostat definition). But the economic growth also led to a deterioration of

the external current account and to pressure on the labour market followed by increases in wages and salaries.

In 1998, a significant economic policy tightening known as the “Whitsun Package” was approved in order to dampen domestic demand and ease the pressure on the labour market. The tightening has resulted in a clear dampening of domestic demand. At the same time, growth in exports has increased, so that a better composition of demand has been obtained with more weight on exports. Furthermore, the rate of wage increases has declined.

The relatively strong growth has contributed to Danish inflation being above that of the euro-area. The underlying inflation (excluding taxes, import prices etc.) is thus quite high, but tax increases also contribute (temporarily) to the increased inflation<sup>2)</sup>.

Even though inflation currently remains somewhat higher than in the majority of the euro-countries, Denmark still fulfils the convergence criterion for inflation. But it must be anticipated that the convergence criterion may be temporarily exceeded during a part of the year 2000. The expected upswing in the euro-area – and the more dampened growth in Denmark – is though expected to contribute to the narrowing of the Danish inflation differential to the euro-countries.

The Government attaches great importance to dampening of wage and price developments so as to comply with the convergence criteria, and also attaches great importance to maintaining the credibility of the fixed exchange rate policy as well as the conditions for a continued and sustainable increase in employment. Thus, the purpose of the economic policy tightening is to ease inflationary pressure through a dampening of both private and public demand. Furthermore, Government efforts to strengthen competition may contribute to reducing the rate of price increases.

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2) Thus, it is assessed that the increase in indirect taxes implemented on January 1<sup>st</sup> 1999 have increased inflation by approximately ½ a percentage point.

The fixed exchange rate policy is a central element of the economic policy. Therefore, it is the task of monetary policy to ensure a stable exchange rate. The exchange rate has been stable at 7.43 –7.45 DKr to euro since the introduction of the euro on January 1<sup>st</sup>.

Danish interest rate developments have basically followed the European developments. There has been a slight increase of the long-term interest differential from 0.3 percentage points at the beginning of 1999 to 0.4 percentage points towards the end of the year. On the other hand, the short-term interest differential has been slightly narrowed during the same period. Following the lowering of the interest rate in December 1998 and in February and April of 1999 by a total of 1¼ percentage points (discount rate and the rate of interest on the banks' current accounts with the Nationalbank), Danmarks Nationalbank increased the lending rate and the interest on certificates of deposit by 0.45 points effective from November 5<sup>th</sup>. The discount rate and the current account rate were only increased by ¼ percentage point. The increases in interest rates took place following the interest rate increase by the European Central Bank of ½ a percentage point.

The economic upswing and the structural improvements have resulted in a surplus on the general government budget since 1997. In 1999 a surplus of 2.9 per cent of GDP is foreseen, while the surplus for 2000 is expected to decrease to 2.1 per cent of GDP, primarily as a result of the decrease in economic growth<sup>3)</sup>. In the year 2001 the surplus will attain 2.2 per cent of GDP. Hereafter the annual surpluses are estimated to be approximately 2½ per cent of GDP until the year 2005.

Due to the long-term effects of the “Whitsun Package”, there will also be an economic policy tightening in the year 2000, while fiscal

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3) These figures are based on ESA95. According to EU definitions (ESA79) of the budget balance and GDP the surplus is expected to be 3.1, 2.4 and 2.5 per cent of GDP in 1999, 2000 and 2001, respectively.

policy will be approximately neutral. For the year 2001 an almost neutral fiscal policy has been assumed.

It is the aim of the Government to moderate the growth in public expenditure in consideration of the pressure on the labour market and the tax burden. A 1.4 per cent increase of public consumption is expected in 1999. According to the agreements concerning the municipal budgets, the municipalities must contribute to ensuring a reduction of the growth rate of government consumption to 1 per cent over the next years. As a result of the underlying expenditure pressure, heavy demands are made on setting priorities and increasing the efficiency within the public sector.

The agreements also entail that municipal taxes must be maintained at the current level in 2000 which on the whole has been complied with in the approved municipal budgets.

Public debt is below the convergence criterion and a further reduction to 50 per cent of GDP in 2000 and to 36 per cent in 2005 is expected<sup>4)</sup>.

It is an important element in the medium-term strategy of the Government that the period until the year 2005 be used to reduce public debt as much as possible. Debt reductions will ensure that, when the time comes, the economic challenges from the ageing of the population can be handled without significant tax increases or reductions of service. Furthermore, the continued consolidation of the general government budget will act as a buffer in the event of an unfavourable cyclical development.

A part of the fall in the tax burden is a result of the continued phasing in of the Whitsun package. On top, a further easing is assumed which should be seen as a reserve related to the possible adjustment of

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4) When the EU definition of GDP is used, debt is expected to constitute 52 and 37 per cent of GDP these two years, respectively.

duties on goods that are especially exposed to border trade. However, the assumed fall in the tax burden relies on realisation of the assumed control of public expenditures and structural improvements on the labour market.

In 1998 several significant structural policy improvements were approved:

- The “Whitsun Package” entails an *adjustment of the tax system* over the years 1999-2002. Tax changes entail, among other things, relatively large cuts in marginal taxes for the lower incomes, lower value of tax deductions of interest payments and increased green taxes. Thus the incentives to work and to save are increased, and at the same time an environmentally sustainable development is supported.
- According to the 3<sup>rd</sup> revision of the *reform of the labour market* a further advance of both the right and the obligation to activation is implemented. At the same time the demands for quality and efficiency in activation will be increased and the effort for the disadvantaged groups of unemployed strengthened. Furthermore, a cut in the benefit period from 5 to 4 years is being implemented and the availability requirements strengthened, cf. box 1.
- Effective July 1<sup>st</sup> 1999 several changes have been implemented to motivate elderly persons to postpone the date of *retirement from the labour market*. Furthermore, the possibilities of keeping a paid job and receiving early retirement benefits at the same time have been improved. Moreover, an early retirement contribution has been introduced, to make the individual’s contribution to the financing of the early retirement scheme more visible.

In connection with the Budget 2000 a reform of *adult and vocational education* (VEU) has been agreed upon which increases responsibility for the education held by the parties of the labour market, and

entails that the VEU-effort becomes more targeted. Furthermore, the guidelines for a reform of *disability pensions* were established in view of making a reform effective on January 1<sup>st</sup> 2003. The reform implies that a strengthened effort be made to create more 'flex jobs'.

A significant increase in the labour supply must be obtained, if the medium-term targets of the Government concerning employment, general government budget etc. are to be reached. Since the demographic development entails a decrease in the work force over the next years, it is necessary to increase the participation rate by each age class.

The reform of the labour market and the new retirement system are important elements in these efforts. Thus, there will be a need for continued structural improvements over the next years if the 2005 targets of the Danish economy are to be realized.

### **Box 1 National Action Plan for Employment, 1999**

In June 1999 Denmark submitted the second national action plan for employment. The action plan is a follow-up on the extraordinary meeting of the European Council in Luxembourg in November 1997, and is a part of the co-ordinated EU strategy for employment. The Danish action plan for employment has been formulated by the Ministry of Economic Affairs and the Ministry of Labour with contributions from several other ministries and the parties of the labour market.

Every year the Council establishes guidelines which the member countries have to consider in their employment policies. In the 1999 action plan it is described how the guidelines for 1998 were implemented, and which employment policy changes have been caused by the 1999 guidelines.

The action plan describes the macro-economic background for the employment situation. For a number of years Denmark has followed a stability-oriented economic strategy which aims at creating a balanced growth and higher employment. At the same time structural reforms of the labour market, taxation and education ensure that the supply of qualified labour can keep up with the increase in employment. During 1998 the pressure on capacity increased in the Danish economy, and the development showed a need for a period of consolidation of the economy and continued structural reforms.

The Danish initiatives related to each guideline are described in the plan. The guidelines - in 1999 a total of 22 - are distributed in four pillars:

- *Improving employability.* In the 3<sup>rd</sup> phase of the reform of the labour market the change from passive to active measures is continued. As early as the autumn of 1998 Denmark fulfilled the guidelines for tackling youth unemployment and for the rate of activation, and the gradual advancement of the activation effort means that, by the end of the year 2000, Denmark will – probably as one of the first member countries – also fulfil the guideline for preventing long-term unemployment. By the reform of the retirement system an important step has been taken in order to increase the supply of labour through postponing retirement from the labour market. Following a dialogue with the parties of the labour market the Government has decided on a reform of adult and vocational education
- *Developing entrepreneurship.* Work is being done to create a culture which as early as in the educational system supports initiative and drive. The structural reforms of the tax system stemming from the "Whitsun Package" contribute to making the tax regulations more employment friendly.
- *Encouraging adaptability of businesses and employees.* For the majority of the work force the working conditions are largely regulated by the collective agreements between the parties of the labour market. In the action plan, the parties of the private labour market stated that the continued process of making agreements more flexible had continued in 1998. Likewise, the parties of the public labour market reported agreements which had been concluded regarding modernization of the organization of work.
- *Equal opportunities for men and women.* The principle of equal opportunities for men and women is sought implemented in all guidelines. The expansion of day-care schemes for children is an important contribution to easing the combination of work and family.

An important element in the common employment strategy is an exchange of positive experiences regarding the employment policy. An account of the positive experiences with the special "youth effort" to decrease youth unemployment is given in the Danish action plan.



### 3. Outlook and targets for economic developments through 2005

In 1998 Denmark fulfilled the convergence criteria by a large margin, cf. table 1.

#### Main features of the medium-term projection

Because of, among other things, the economic policy measures taken, a dampened growth in GDP in 1999 and 2000 is expected. This is necessary to ensure a more balanced development, with a dampening of inflationary pressures and a recovery of the external current account. The medium-term projection is summarized in table 2, and in table A.1 a comparison to the previous convergence programme is shown.

During the period 2001-2005 it is estimated that growth in GDP will reach the medium-term growth-potential of approximately 2 per cent annually.

In 1999 a surplus of almost 3 per cent of GDP is expected on the general government budget. It is estimated that the surplus will decrease to 2 – 2¼ per cent in 2000 and 2001 due to, among other things, a slight increase in unemployment.

**Table 1 The convergence situation in 1998**

	Consumer prices <sup>1</sup>	Long-term interest rate <sup>2</sup>	General government budget <sup>3</sup>	Government gross debt <sup>3</sup>
	Percentage change	Per cent	Per cent of GDP	Per cent of GDP
Denmark . . . . .	1.3	4.9	1.0	58.0
EU-countries . . . .	1.7	4.9	-1.5	69.3
Euro-countries . . .	1.3	4.7	-2.1	73.5
Convergence criterion . . . . .	2.2	6.6	-3	60

1. EU Harmonized Index of Consumer Prices
2. 10-year government bonds
3. In accordance with the latest decisions by Eurostat regarding the interpretation of the ESA-79 standard (the "old" European system for national accounts). According to revised figures from Statistics Denmark the general government surplus in 1998 is 0.3 percentage points higher than stated here.

**Table 2 Key figures for the convergence programme**

	1998	1999	2000	2001	2002	2003	2004	2005
<i>Percentage change</i>								
Real GDP .....	2.7	1.3	1.6	2.0	2.3	2.2	2.1	2.0
Consumer price index <sup>1</sup> .....	1.9	2.5	2.3	1.9	1.6	2.0	1.9	1.9
<i>Per cent of GDP</i>								
General government budget <sup>2</sup> .....	0.9	2.9	2.1	2.2	2.3	2.5	2.6	2.8
Structural budget balance <sup>2</sup> .....	-0.8	1.8	1.9	2.3	2.3	2.5	2.6	2.8
Gvt. gross debt (year-end) <sup>2</sup> .....	55.6	52.8	50.1	47.5	44.5	41.5	38.7	35.9
Balance of current account .....	-1.2	0.0	0.2	0.5	0.7	0.9	1.0	1.1
Foreign debt (year-end, net) <sup>3</sup> .....	25.7	24.9	23.9	22.5	21.6	19.7	17.8	16.0
<i>Per cent</i>								
Long-term interest rate (10-year government bond) .....	4.9	4.9	5.6	5.6	5.2	5.1	5.1	5.1
<i>Per cent of the work force</i>								
Unemployment .....	6.4	5.6	5.7	5.9	5.6	5.2	5.1	5.0
Do. EU-definition .....	5.1	4.4	4.5	4.8	4.5	4.1	4.0	4.0

Sources: Regarding the years 1999-2001 figures are according to *Economic Survey, December 1999*. The years 2002-2005 are in accordance with *Denmark 2005 – a head start on a new century*, August 1999.

1. From the year 2000 a change of the methods used for calculating the consumer price index takes effect. The change will bring the increase closer to the EU Harmonized Index of Consumer Prices (HICP). The estimates shown for the years 2000-2005 are in accordance with the changed methods of calculation.
2. Contrary to the figures concerning the public sector in table 1, regarding the convergence situation, the figures in this table are in accordance with the ESA95 definitions. From the year 2000 Eurostat changes to these definitions (which are a part of the new standard for national accounts, adapted by Statistics Denmark in the autumn of 1997). The latest revision by Statistics Denmark of the general government budget for 1998 have not been incorporated. According to the revised figures public deficit in 1998 was 0.3 percentage point higher than indicated here.
3. Compared to Economic Survey of December 1999 foreign debt has been reduced in 1998-2001 due to a downward adjustment of the debt at the end of 1998 (of DKr 8 billion). On the other hand the debt for the years 2002-2005 has been upgraded compared to *Denmark 2005* due to an earlier revision of debt at the end of 1998.

In 2002 a surplus of 2¼ per cent of GDP is expected. Thus, it is expected that in the next three years, the Government's medium-term budget targets will be fulfilled. In 2002 it is expected that the debt ratio will be reduced to less than 45 per cent.

Employment grows by an average of approximately 18,000 persons (¾ per cent) annually through 2005, and unemployment is estimated to decrease to 5 per cent in 2005.

***Tabel 3 GDP and consumption deflators, consumer and net price indices and harmonized index of consumer prices***

Annual change in per cent	1998	1999	2000	2001	2002	2003-2005
GDP deflator	2.1	2.4	2.3	2.0	2.4	2.6
Consumption deflator	1.8	2.4	2.3	1.9	1.8	2.1
Consumer price index <sup>1</sup>	1.9	2.5	2.3	1.9	1.6	1.9
EU Harmonized Index of Consumer Prices (HICP)	1.3	2.0	2.2	1.9	...	...
Net price index <sup>1</sup>	1.5	2.1	2.2	1.9	...	...
Euro-11 inflation (HICP) <sup>2</sup>	1.2	1.2	1.5	1.5	...	...

1. Calculation methods for consumer and net price indices will be changed in January 2000, cf. annotation 1 table 2.
2. Source: EU-Commission Autumn Forecast.

Equilibrium of the current account is expected in 1999 with a surplus from 2000 and ahead and, thus, foreign debt will be reduced to 16 per cent of GDP in 2005.

It is expected that, due to the dampened growth and an improvement of labour market structures, increase in wages will go down from 4½ per cent in 1999 to 4 per cent in 2000 and to 3½ per cent in 2001. In the rest of the projection period the annual increase is expected to be just below 4 per cent.

Consumer prices are expected to increase by 2½ per cent in 1999 and by 2¼ per cent in 2000, and during the rest of the period the growth rate is expected to be 1½-2 per cent annually.

In 1999 the EU-harmonized Index of Consumer Prices (HICP) has – as earlier – increased more slowly than the national consumer price index, and for the year as a whole HICP is estimated to increase by 2 per cent. Over the next years only marginal differences will be seen between the two indices<sup>5)</sup>.

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5) From January 2000 a change in the calculation methods of the national consumer price index takes place, which will bring the increase in this index close to the increase in the EU-Harmonized Index of Consumer Prices (HICP), by which the

During 1999 the increase in consumer prices has moved close to the convergence limit which must be seen especially as an effect of the relatively higher wage increases in Denmark, which are due to Denmark's position quite far ahead in the economic cycle. On top of this comes the increase in green taxes.

As mentioned, there may be a risk that, for a limited period of time in the beginning of the year 2000, Denmark may not comply with the convergence criterion for inflation on a 12-month basis. It is estimated that the relatively high inflation in Denmark is a temporary situation which will end when the dampening of the growth in domestic demand and the reduction in wage increases begin to take effect.

#### **Assumptions regarding international developments.**

The assumptions regarding the international developments underlying the projections can be seen in table 4.

***Table 4 Assumptions regarding international developments***

	1999	2000	2001	2002	2003	2004	2005
<i>Annual growth (per cent)</i>							
Real GDP abroad (weighted by export)	2.2	2.8	2.8	2.6	2.5	2.3	2.2
Danish manufactured export markets (real) . . . . .	5.5	7.1	7.2	5.2	5.0	4.6	4.1
Hourly wages abroad (weighted by exports) . . . . .	3.1	3.1	3.3	4.0	3.9	3.9	3.9
10-year euro interest (per cent)	4.5	5.2	5.3	4.9	4.9	4.9	4.9

Annotation: The figures for the years 1999-2001 are in accordance with the assumptions in *Economic Survey, December 1999*. There are minor deviations from the latest Commission Forecast of the autumn of 1999. The most important deviation is that a growth in German GDP of 1.1 per cent in 1999 is assumed here, while the Commission Autumn Forecast assumes a growth of 1.5 per cent.

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convergence is measured. It is estimated that the change in calculation methods will reduce the increase of the domestic index of consumer prices by approximately 0.3 percentage points in 2000 and a little more in the following years compared to the method currently used.

The market growth for Danish manufactured exports is expected to increase from 5½ per cent in 1999 to 7¼ per cent in 2001 along with the improved economic trends in Europe. Hereafter market growth is expected to gradually dampen to 5¼ per cent in 2002 to just over 4 per cent in 2005.

The rate of increase in wages abroad is expected to go up from 2.8 per cent in 1998 to 4 per cent in 2002 due to the stronger growth in Europe<sup>6)</sup>. Together with the expected trend of wages and salaries at home, this will ease the Danish situation regarding competitiveness and convergence for inflation. For the rest of the projection period it is assumed that the rate of increase in international wages stays just under 4 per cent annually.

Against this background the real growth in the Danish manufactured exports is expected to gradually increase from 2 per cent in 1998 to 6½ per cent in 2001. Subsequently, growth in manufactured exports is expected to decrease to 4¾ per cent in 2005.

The long-term interest rate in the euro-area is expected to increase from 4.5 per cent annually in 1999 to 5.3 per cent in 2001. Subsequently it is expected to fall below 5 per cent in 2002-2005. Against this background the Danish long-term interest rate is expected to increase from 4.9 per cent in 1999 to 5.6 per cent in 2001. Thereafter, it is expected to decrease to just over 5 per cent, because the long-term interest differential to the euro is expected to be reduced from 0.4 percentage points in 1999 to 0.2 percentage points in 2005.

During 1999 the Danish krone has remained stable against the euro and the value of euro in kroner is slightly lower than the central parity rate. At present the long-term interest differential to the euro-area is 0.3 –0.4 percentage points.

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6) In some areas the assumptions regarding international developments deviate from the Autumn Forecast 1999 by the Commission, cf. annotation for table 4.

## 4. General government budget

It is the aim of the Government to maintain a surplus on the general government budget as an average over the economic cycle. Thus the aim is to reduce public debt. Consolidation has been one of the main targets of the Danish Government. This target is kept so as to reduce public debt to 45 per cent of GDP in 2002 and to 36 per cent in 2005, cf. table 5.

In 1999 the surplus of the general government budget is expected to be 2.9 per cent of GDP. In the year 2000 a surplus of 2.1 per cent of GDP is foreseen. In the years 2001 and 2002 a surplus of 2.2 per cent and 2.3 per cent of GDP respectively is expected. Towards 2005 it is assumed that the general government surplus will increase to 2.8 per cent of GDP.

Expenditure on transfer payments and interest will constitute a diminishing share of GDP through 2005. The consolidation of the general government budget has led to a reduction of public interest payments. Thus, it is estimated that public net interest expenditure will constitute 2 per cent of GDP in 2000 against 2.8 per cent in

**Table 5 General government budget**

<i>Per cent of GDP</i>	1999	2000	2001	2002	2003	2004	2005
Primary expenditure . . . . .	50.2	50.4	50.0	50.0	49.5	49.2	49.0
Primary revenue . . . . .	55.2	54.5	54.0	53.6	53.1	52.7	52.4
Primary balance . . . . .	5.1	4.1	4.0	3.6	3.6	3.5	3.4
Net interest payments . . . . .	2.2	2.0	1.7	1.3	1.1	0.9	0.6
Budget balance . . . . .	2.9	2.1	2.2	2.3	2.5	2.6	2.8
Hereof: . . . . .							
State and municipalities . . .	1.3	0.6	0.7	0.9	1.2	1.3	1.5
Funds . . . . .	1.6	1.5	1.5	1.4	1.3	1.3	1.3
Budget balance, EU-definition <sup>1</sup>	3.1	2.4	2.5	2.6	2.8	2.9	3.1
Primary balance, EU-definition <sup>1</sup>	5.0	4.1	3.9	3.6	3.6	3.5	3.4
Public debt . . . . .	52.8	50.1	47.5	44.6	41.6	38.7	35.9
Public debt, EU-definition <sup>1</sup> . . .	55.0	52.3	49.5	46.5	43.4	40.4	37.4

1) ESA79

1996. In the year 2005 net interest expenditure is expected to constitute 0.6 per cent of GDP, cf. table 5.

A sensitivity analysis has been carried out below – focused on budget balance and debt – where the assumptions made, regarding interest rates, market growth and government consumption differ from the reference scenario. The calculations have been made under the assumption that these changes do not lead to economic policy initiatives. In short, the sensitivity analysis shows that the progress of the past years has made the Danish economy able to sustain such deviations from the reference scenario, while still keeping a clear distance to the threshold values of the convergence criteria.

The budget balance is quite sensitive to cyclical fluctuations. Most estimates point towards that an increase in GDP of 1 per cent over the trend in GDP improves the budget balance by between 0.5 per cent and 0.8 per cent of GDP. This means that, if growth towards 2005 is 1 percentage point lower than assumed (i.e. an annual growth in GDP of approximately 1 per cent), the budget balance will be 3-5 percentage points lower in 2005 than would otherwise be the case. In other words, a decrease in growth will lead to a deficit on the budget balance in 2005 of 0-2 per cent of GDP. Thus, even in such a depressive scenario Denmark will fulfil the convergence criterion by a certain margin.

The structural balance is expected to improve from -0.8 per cent of GDP in 1998 to 1.8 per cent of GDP in 1999, cf. table 6. The improvement of the structural balance from 1998 to 1999 is due to especially the implementation of the special ATP-saving. For 2005 a surplus of 2.8 per cent of GDP is expected for the structural balance.

Basically the municipalities must achieve an approximate equilibrium between revenue and expenditure, while other sectors – the State, pension funds and other funds – are expected to show a surplus

**Tabel 6 Fiscal policy 1997-2005**

	1997	1998	1999	2000	2001	2002	2005
Budget balance (1) . . . . .	0.1	0.9	2.9	2.1	2.2	2.3	2.8
Cyclical influence (2) . . . . .	1.5	1.8	0.8	0.2	0.0	0.0	0.0
Effect of special items (3) . . . . .	0.1	-0.1	0.3	0.0	0.0	0.0	0.0
Structural balance (1)-(2)-(3) . . . . .	-1.5	-0.8	1.8	1.9	2.3	2.3	2.8

or equilibrium in 2001, cf. table 5. It is expected that as an average this will be maintained through 2005.

In the convergence programme the tax burden falls from 51 per cent of GDP in 1999 to 48 per cent of GDP in 2005, cf. table 7. A part of the fall in the tax burden is a result of the continued phasing in of the Whitsun package and a reserve to solve border trade problems as mentioned above while the rest is a result of assumed lower revenue from corporate taxes etc. compared to the extraordinarily high level in 1999. This development, together with the target of continued consolidation of debt, entails that a tight framework has been set for

**Tabel 7 Composition of the general government budget**

<i>Per cent of GDP</i>	1997	1998	1999	2000	2001	2002	2005
Budget balance:	0.1	0.9	2.9	2.1	2.2	2.3	2.8
Public expenditure/cost pressure . . . . .	57.2	55.9	54.8	54.6	53.9	53.3	51.5
Primary expenditure . . . . .	51.4	50.7	50.2	50.4	50.0	50.0	49.0
Government consumption . . . . .	25.4	25.6	25.7	25.7	25.7	25.7	25.4
Government investment . . . . .	1.9	1.7	1.7	1.7	1.7	1.7	1.6
Transfer payments . . . . .	18.9	18.1	17.7	17.7	17.5	17.5	16.8
Interest payments . . . . .	5.8	5.2	4.6	4.3	3.9	3.4	2.5
Public revenue . . . . .	57.3	56.8	57.6	56.8	56.2	55.7	54.3
Tax burden . . . . .	49.6	49.3	50.8	50.0	49.7	50	48
Personal tax and import and production tax . . . . .	26.6	25.9	26.4	25.9	25.8	25.3	24.1
Property tax and property value tax . . . . .	1.0	1.0	1.1	1.7	1.8	1.7	1.8
Tax on real rate of return and company tax . . . . .	3.7	3.6	4.1	3.3	3.2	3.2	3.2
Compulsory premiums . . . . .	1.6	1.6	2.2	2.4	2.5	2.4	2.3
Duties . . . . .	16.7	17.1	17.0	16.7	16.5	16.6	16.9



**Table 8 Composition of changes in public debt**

<i>Per cent of GDP</i>	1997	1998	1999	2000	2001	2002	2005
Debt ratio . . . . .	61.3	55.6	52.8	50.1	47.5	44.6	35.9
Changes in debt ratio . . . . .	-3.8	-5.7	-2.8	-2.6	-2.6	-2.9	-2.8
- Budget balance . . . . .	-0.1	-0.9	-3.0	-2.2	-2.3	-2.5	-3.0
- Growth contribution . . . . .	-3.3	-2.8	-2.1	-2.1	-2.1	-2.3	-1.8
- Financial items etc. <sup>1</sup> . . . . .	-0.3	-2.0	2.3	1.7	1.7	1.9	1.9

Annotation: Calculations are based on the new standard for national accounts ESA95. Table 5 presents calculations of debt according to both ESA95 and ESA79 (the "old") standards for national accounts.

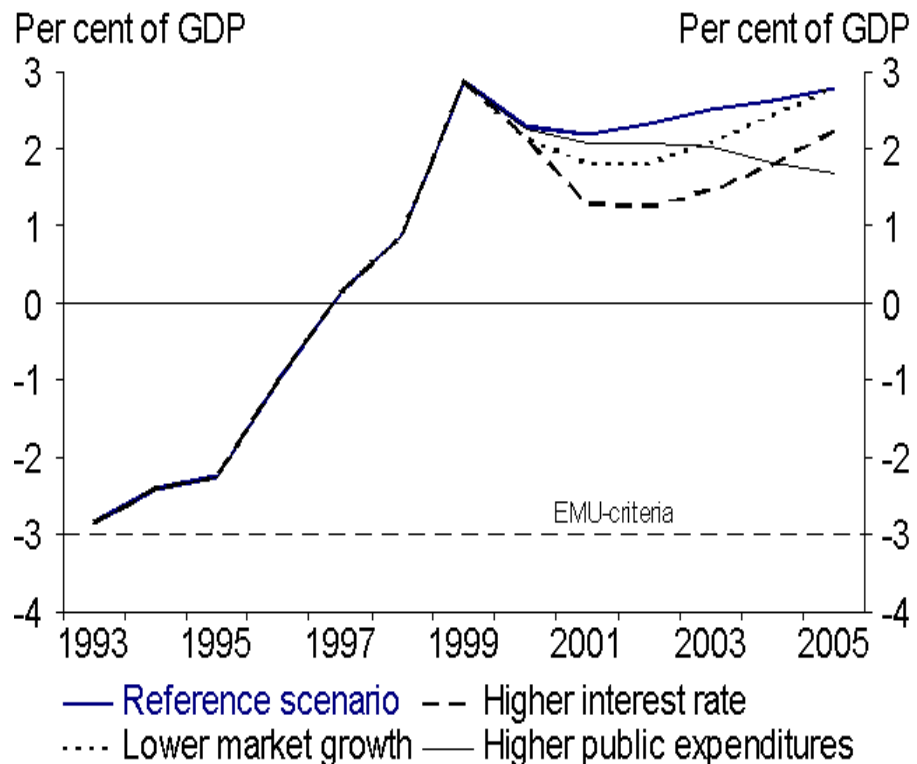
1. Revenue following the sale of public assets (privatization etc.) entails a reduction of debt. In years without major privatizations, this item tends to be positive (i.e. pull towards an increase in the debt ratio) because debt is a *gross* term, and the level of gross debt tends to increase, also in years with a (smaller) surplus.

the development of public expenditure over the next years. The target is, thus, that real growth in government consumption does not exceed an average of 1.0 per cent through 2005. In the years 1999 and 2000 real growth in government consumption of 1.4 and 1.2 per cent respectively is expected. At the same time it is the target to keep growth in public investment at a low level - an average of 1 per cent during the years 2001-2005.

## 5. Sensitivity analysis

In the following three analyses of the sensitivity of the Government targets of development in the general government budget and public debt are presented. The effects of an international interest rate which is 1 percentage point higher each year are analysed, along with a dampened growth in export markets of 1 per cent each year and an additional growth of government consumption of 0.5 per cent each year. The last analysis has been performed by increasing public employment by an additional 4,250 persons annually.

**Figure 1 General government net lending**

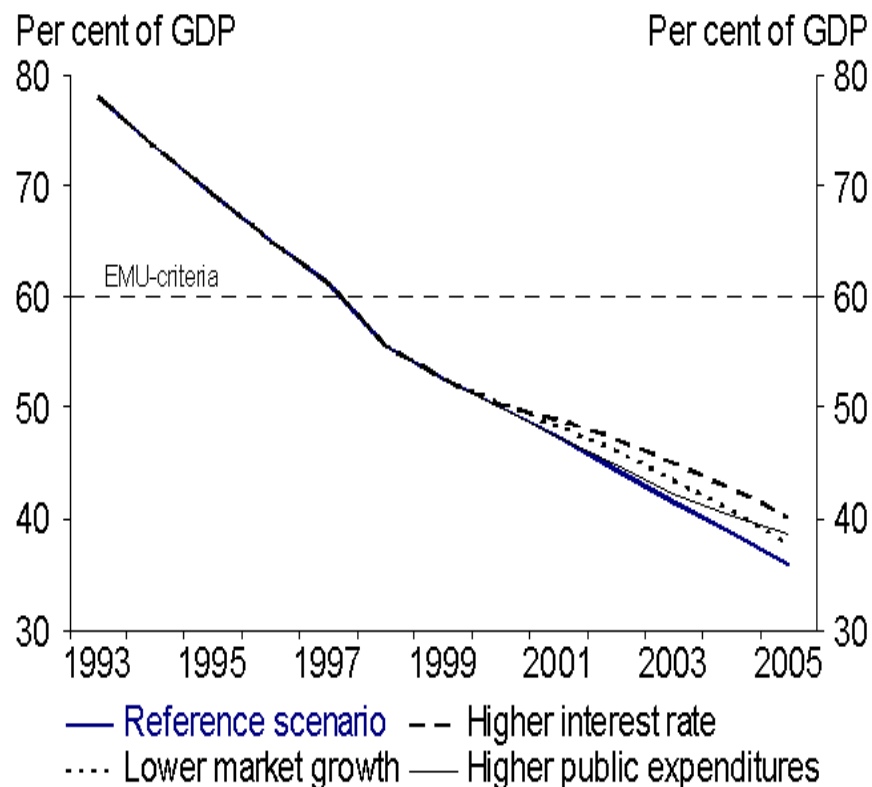


All the analyses show that the improvements of Danish economy over the past few years have made the Danish economy able to sustain such deviations from the reference scenario without problems relating to convergence criteria.

**Increase in interest rate levels**

An increase in the international interest rate of 1 percentage point reduces the budget balance surplus by around 1 per cent of GDP from the year 2001 and ahead, and consequently the budget balance will be 2.2 per cent of GDP in 2005, cf. figure 1.

Thus, an increase in interest rate will lead to an increase in public net interest expenditure - since the public sector is a net debtor - and to a decrease in investments in the economy and a temporary decrease in employment. Thereby, the public sector will receive fewer taxes and get an increase in expenditure for unemployment benefits etc. However, this lower activity in the economy will, in the long-term, lead to a decrease in domestic inflation which in turn leads to an

**Figure 2 Government gross debt**

increase in net exports. Thus, some of the lost activity is generated in the economy, which has a positive impact on the budget balance. For public debt this means that government gross debt in 2005 will be just over 42½ per cent of GDP against 35.9 per cent in the reference scenario, cf. figure 2.

### Lower export market growth

A decrease in export market growth will lead to a decrease in activity in the economy. However, since this leads to a decrease in wage pressure and thus lower inflation, the fall in export market growth is compensated by an overall improvement of competitiveness, so that the total net export will remain unchanged after five years. On the whole a deterioration of the budget balance of 0.5 per cent of GDP will be seen after two years, but subsequently it will return to the point of origin i.e. 2.8 per cent of GDP in 2005, cf. figure 1. Regarding the debt, this also leads to only a slight deterioration. Thus, it will

increase slightly in 2005, i.e. 38.8 per cent of GDP as opposed to 35.9 per cent in the reference scenario.

### **Increase in government consumption**

In the short-term an increase in public consumption will lead to an increase in economic activity, and, thus, at first the effect on the budget balance is limited, since tax proceeds increase accordingly. However, in the long-term this leads to higher inflation, and thus to a decrease in net exports. Consequently, the total effect on the budget balance is a deterioration, resulting in the 2005 budget balance being 1.7 per cent of GDP. Debt will end at 40 per cent of GDP in 2005 in this analysis against 35.9 per cent in the reference scenario, cf. figures 1 and 2.

## Appendix: Changes in estimates

According to the latest assessment of economic trends, the growth in GDP in Denmark in 1999 and 2000 will be somewhat slower than assumed in the previous convergence programme<sup>7)</sup>, while the growth in 2001 remains largely the same.

The downward adjustment of growth is mainly due to a weaker development in private consumption and construction of dwellings. This has led to a significant improvement of the external current account throughout 1999. It is estimated that a balance of the current account will be reached in 1999 - and a surplus in 2000-2001 - against a deficit in 1998 of 1.2 per cent of GDP.

The above mentioned deficit in 1998 was significantly larger than formerly expected, and this is the background for the downward adjustment of the balance of the current account, compared to the previous convergence programme.

Even though the growth in GDP is lower, unemployment has decreased more than expected, and the unemployment estimates have been downgraded. In spite of this, the wage increases have been declining throughout 1999. In the years 2000 and 2001 a somewhat lower increase in wages is expected, because of, among other things, the development of wages and salaries through 1999.

The current estimate of the 1999 increase in consumer prices of 2.5 per cent is slightly higher than formerly assumed, which, among other things, is due to the increase in oil prices.

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7) Cf. the comparison with the previous convergence programme in table A.1. As mentioned, the update of the convergence programme for 1999-2001 equals the estimates in *Economic Survey, December 1999*, while the scenario for the period 2002-2005 has been based on the medium-term projections by the Government in *Denmark 2005- a head start on the new century*, August 1999.

Disregarding the effect of the change of calculation method for the consumer price index starting in January 2000, a smaller upward adjustment of the 2000 price increase has been made, due to, among other things, larger increases in excise duties in accordance with the final budget for the year 2000.

The surplus expected on the general government finances in 1999 of 2.9 per cent of GDP is 0.6 percentage points higher than formerly anticipated. In return the estimated surpluses in 2000 and 2001 have been slightly downgraded, due to, among other things, a slight augmentation in public demand in the year 2000.

#### **Adjustments of the medium-term projections.**

Compared to the previous convergence programme, no major changes in the assessments of the 2002-2005 scenario have been made in the medium-term projection of August 1999, cf. table A.1.

However, it must be anticipated that the surplus on the current account will be lower through the period than formerly estimated. Thus, at the end of 2005 foreign debt will be somewhat higher than before<sup>8)</sup>. The Government still aims at eliminating foreign debt, but the pace of the reduction has been slowed down.

The increase in employment through 2005 has been slightly downgraded. But it is still expected that the target of reducing unemployment to 5 per cent in 2005 will be reached.

The public surplus at the end of 2005 is expected to be less favourable than formerly anticipated (2.8 against 3.3 per cent of GDP), due to, among other things, the lower employment and thus a smaller tax base. However, in 2005 the debt ratio will only be marginally higher (36 against 35 per cent).

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8) On top of this come the effects of an upward revision of foreign debt by the end of 1998.

**Tabel A.1 Main features of developments, and comparison with the previous convergence programme**

	1998		1999		2000		2001		2002		2003-2005	
	Nov 98	Dec 99	Nov 98	Dec 99	Nov 98	Dec 99	Nov 98	Dec 99	Nov 98	Dec 99	Nov 98	Dec 99
<i>Real growth, per cent</i>												
Private consumption . . . . .	3.1	3.5	1.4	0.9	1.8	1.3	1.7	1.7	2.0	2.1	2.4	2.4
Government consumption . .	2.1	3.0	0.9	1.4	1.0	1.2	1.0	1.0	1.0	1.0	1.0	1.0
Government investment . . . .	-8.5	-2.7	2.0	-2.0	1.0	6.5	1.0	1.0	1.0	1.0	1.0	1.0
Residential investment . . . .	1.0	5.1	-0.5	-2.0	-0.3	-4.0	0.7	0.0	1.5	3.0	2.9	3.6
Business investment . . . . .	7.7	8.5	2.8	2.8	2.7	1.0	2.9	1.9	2.9	4.1	3.1	3.4
Total domestic demand <sup>1)</sup> . . .	3.4	4.6	1.4	0.2	1.6	1.3	1.7	1.7	1.9	2.2	2.2	2.2
Export of goods and services	2.5	1.4	2.9	3.4	4.2	4.0	4.2	3.9	4.3	4.5	4.1	4.0
- Hereof manufactures . .	4.3	2.1	4.2	3.5	4.9	5.7	4.9	6.5	5.0	5.2	4.8	4.6
Import of goods and services	4.5	6.4	2.3	0.7	3.4	3.2	3.7	3.4	4.0	4.3	4.1	4.3
GDP . . . . .	2.6	2.7	1.7	1.3	2.0	1.6	1.9	2.0	2.1	2.3	2.2	2.1
<i>Increase, per cent</i>												
Consumer price index . . . . .	1.8	1.9	2.3	2.5	2.4	2.3	2.1	1.9	2.0	1.6	2.2	1.9
Hourly wage rate . . . . .	4.5	3.9	4.5	4.5	4.5	4.0	3.9	3.5	3.6	3.9	3.7	3.9
Interest, 10-year government bond (per cent) . . . . .	5.0	4.9	4.9	4.9	5.6	5.6	5.6	5.6	5.9	5.2	5.9	5.1
Change in employment (1,000 persons) . . . . .	49	56	16	19	22	8	22	12	25	22	25	21
Level of employment (per cent) <sup>2)</sup> . . . . .	73.8	73.7	74.2	74.2	75.4	74.3	75.9	74.6	76.4	74.6	78.1 <sup>3)</sup>	75.7 <sup>3)</sup>
Unemployment, per cent of work force . . . . .	6.4	6.4	6.1	5.6	6.1	5.7	6.0	5.9	5.9	5.6	5.0 <sup>3)</sup>	5.0 <sup>3)</sup>
<i>Per cent of GDP</i>												
Current account . . . . .	-0.6	-1.2	0.0	0.0	1.0	0.2	1.3	0.5	1.6	0.7	2.0 <sup>3)</sup>	1.0 <sup>3)</sup>
Foreign debt (year-end, net) .	23.4	25.7	22.4	24.9	19.1	23.9	17.0	22.5	14.7	21.6	7.4 <sup>3)</sup>	16.0 <sup>3)</sup>
Budget balance . . . . .	1.0	0.9	2.3	2.9	2.6	2.1	2.4	2.2	2.4	2.3	3.3 <sup>3)</sup>	2.8 <sup>3)</sup>
Government debt (year-end)	56.1	55.6	53.1	52.8	48.6	50.1	45.9	47.5	43.5	44.5	34.7 <sup>3)</sup>	35.9 <sup>3)</sup>

Annotation: The figures concerning the public sector are according to ESA95- definitions (cf. annotation 2, table 2). Consumer prices equal the domestic consumer price index, and unemployment is national definition. The method of calculation for the consumer price index will be changed from January 2000 and foreign debt has been readjusted, cf. table 2. 2003-2005 are annual averages, if not otherwise indicated.

1) Inclusive inventory changes. 2) Employed compared to ages 15-66. 3) Year-end 2005-level.